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The Value of a Branch Is Measured in More than Deposit Ranges

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SANFORD ROSE'S Feb. 17 column entitled "There's Still Hope For the Branch" presents a fairly balanced view of a vitally important retail banking topic, namely, the future of the branch.

The editorial did not dwell on the controversial finding by one consulting firm that around half of all branches are unprofitable and by implication should be closed. Rather, the comments focused on various strategies suggested by another consulting firm to enhance branch performance. Based upon that firm's experience with one regional bank with over 200 branches, those strategies reportedly could result in a remarkable turnaround: The proportion of branches exhibiting negative returns could fall from 48% to 10% or 11%, and the proportion earning less than the corporate hurdle rate could drop from 62% to 21%.

This case study emphasizes the importance of distinguishing between branches that are truly profitable and those that are not. A truly unprofitable (i.e., negative net present value) branch that is a chronic underpertormer may have to be closed, sold, swapped, or otherwise disposed of. This branch disinvestment alternative is usually reserved for those problem or serious problem branches where locational (i.e., the site, immediate area, and market area) factors have been identified as the primary causative agents.

Obviously, there is a whole set of nonlocational determinants of branch performance including the familiar marketing mix "P" variables of pricing, product, promotion, personnel, and other management and operating policies. It appears that the performance-enhancing strategies recommended in the cited case study were primarily of the nonlocational variety such as changes in pricing, personnel, and corporate policies.

A hasty recommendation that the subject bank dispose of 48% to 62% of its branches, which was not made in this instance, would clearly have been totally inappropriate and unjustified. Rather, it seems from that case study that the proportion of truly unprofitable branches that might have to be divested would be between 10% and 21%.

The '80/20 Rule'

Our consulting experience since 1975 as specialists in branch evaluation and location research exclusively for financial institutions has confirmed our version of the familiar "80/20" rule: Approximately 20% of a financial institution's branches cause 80% of its branch problems. The first or lowest 10% are categorized as problem or serious problem offices often requiring branch divestiture; the second 10% are problem, near problem, or potential problem offices sometimes necessitating such extreme action.

We feel that the conservative approach to branch planning dictates use of our 80/20 rule to trim the fat from the retail branch network as appropriate. The case study cited in the editorial would appear to support this rule. However, going upwards to 40% means cutting into the meat, and at or over 50% would mean cutting into the bone.

We would recommend that serious consideration be given to any such plans to drastically reconfigure a retail branch network. Such radical and irreversible surgery on a branch network might be appropriate if management has decided to change the bank's branching objectives or its entire retail orientation. Otherwise, a typical retail bank or thrift closing 40%-60% of its offices would certainly represent an unusual set of circumstances.

The previously referenced study concluded that a bank or thrift branch needs $20 million-$25 million in deposits today just to break even (see "Study Finds Half of Nation's Branches Unprofitable,' *American Banker*, October 10, 1987, page 3). It was noted that the proportion of all U.S. bank and thrift branches that were or were destined to be unprofitable was at least 40% but as high as 60%, since that percentage of branches had $20 million or less in deposits in 1986.

We agree that there is a generally positive relationship between branch profitability and local retail core deposits. However, this is not a perfect relationship, and bankers must be careful not to equate branch profitability and total branch deposits.

Break-even deposit levels differ among banks and among branches within any bank because of different fixed and variable expense structures. For example, we have seen some branches with deposits in excess of $25 million that are unprofitable because of their cost structures.

Profitability Differs from Deposits

Conversely, it has been our experience that many branches in the $10 million-$20 million range are profitable, and any wholesale recommendation to close branches simply because they are in this deposit range would be a mistake.

In fact, we have seen some small branches with deposits of less than $10 million that are profitable because of low overhead and outstanding loan portfolios. Why would we even have loan production offices with technically no deposits if these facilities were not profitable? Different offices can serve different delivery system objectives and still be profitable.

For these and other reasons it is difficult to generalize on a universal break-even level or even range for all offices in all areas. For those wishing to make decisions with deposit break-even analysis, the conservative approach to branch planning suggests use of relatively low ranges of local retail core deposits.

For example, at the beginning of this decade an assumption of a $6 million-$10 million range for seasoned offices would have been appropriate. Increases in fixed and variable costs, among other things, since then would obviously imply a higher range. An assumed range of $10 million-$12.5 million in local retail core break-even deposits, precisely one-half of the previously-cited study's finding of $20 million-$25 million, would be more representative of the conservative approach to branch planning in today's environment.

Because branch profitability is much more than just the level of total deposits, we prefer use of discounted cash flow techniques (e.g., net present value) over deposit break-even analysis in branch investment and disinvestment capital budgeting decisions.

Many financial institutions, especially the larger ones, have formal branch profitability measurement systems. It has been our experience that most of those who do not have such systems attempt to use some type of informal measurement procedure to try to monitor absolute and relative branch growth, activity, and cost levels. It would indeed be surprising to learn that management and their formal or informal branch profitability measurement procedures have been so far off to allow 40% to 60% of all branches to continue operating if they were in fact unprofitable.

It would be easy to end this controversy if all financial institutions had formal branch profitability measurement systems under some type of generally accepted accounting procedure and then regularly disclosed results. While these data obviously do not exist, this thought raises the question as to whether or not such actual data for the entire bank, not the branch, would be useful evidence in disputing the conclusion that a branch must be $20 million-$25 million in deposits to break even. Total bank data obviously includes all types of home-office overhead items, many of which would not be relevant for a branch.

Keeping these and other obvious differences in mind, it is interesting to note that only 27% of the approximately 4,500 FDIC-insured banks with assets (not deposits) of under $25 million in 1987 were unprofitable, according to the Federal Deposit Insurance Corp. The comparable proportion of the under 400 thrifts insured by the Federal Savings and Loan Insurance Corp. in this asset range that were unprofitable was less than 25%, according to the U.S. League of Savings Institutions.

These data obviously include many newly chartered institutions that typically run unprofitable positions during their start-up years. Our guess is that the 73% of banks and 75% of thrifts with assets under $25 million that made money last year might likewise question the conclusion that a branch must be $20 million-$25 million in deposits to break even.

If shareholders, bank analysts, and other interested parties are led to believe that a branch must have $20 million-$25 million in deposits to be profitable, bank management must be prepared to justify their actions if they allow such "unprofitable" facilities to continue operating. Of course, branch deposit data are publicly available at little or no cost on at least an annual basis.

Since the market can relate to profit and loss much more than assumed or estimated deposit break-even levels, we therefore recommend that management focus on branch profitability. This means, among other things, being able to understand and explain that different branches can be profitable serving different delivery system objectives, even if reported deposit levels are below $20 million or $10 million in some cases.

We should parenthetically mention that just the thought of closing half the nation's branches for whatever reason conjures up all types of public-policy implications. For example, many but not all small-deposit branches are in rural areas, small towns, or depressed neighborhoods of metropolitan areas. Often times these branches represent the only remaining depository financial institution in those areas.

Regardless of the area, survey research shows that the appeal of branch banking to customers is strong with eight out of ten people using branches as much as ever or more than in the past (see Fourth Annual Consumer Survey results in "Branch Banking Concept Retains Strong Appeal," *American Banker*, October 12, 1987, page 1). Considering the increasing momentum of the new consumerism movement in banking and the industry's continued desire to improve its public image and expand its powers, just the idea of closing half the nation's branches is not the most timely one.

Bankers will continue to close, sell, or otherwise dispose of unprofitable branches, just as they will establish new branches that promise to be profitable. However, we believe that such branch disinvestment and investment activities should be based on a conservative, selective, and analytical approach to branch planning as suggested above.

It has long been our opinion that the branch will continue to be the dominant delivery system for retail banking during the next decade, through the turn of the century, and beyond. And, as long as there is hope for retail banking, there is still hope for the branch.■

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